Chapter Five

Money and Fiscal Powers

The importance of money

Arrangements around the raising, sharing, and spending of money are critically important, both politically and economically, for the functioning of federal systems.

The truism that money matters applies as much in federal systems as it does in life generally.

First, arrangements around who determines and collects taxes and other revenues and who spends them, how, and on what are fundamental to the real division of powers in a federal system. They can significantly alter the apparent legislative powers of the two orders of government. In particular, central governments often use their very strong fiscal powers to influence or control constituent-unit governments in various ways.

Second, the ways in which money is raised and spent can significantly affect the economic health of a federation.

- **Tax and spending incentives** affect the efficiency and performance of the economy. They can be used by constituent units to try to attract businesses and citizens to locate and invest within their boundaries. While some tax and spending competition can be healthy, it can also be costly in attracting economic activity to inefficient locations and causing a loss or misuse of revenues.

- **Revenue raising** (taxes, charges, debt, issuance of money) **and**

spending by governments affects the total level of activity in the economy whether policies are expansionary or contractionary. Some federations have had major problems managing coherent fiscal and monetary policies, with serious bouts of inflation and exaggerated economic cycles of boom or bust.

Fiscal and monetary powers are important both economically and in their larger impact on the roles of the two orders of government.

Assignment of revenue powers

There are principles for the effective assignment of revenue-raising powers between governments in federations. In practice, however, there is great variation, largely because the constitutional arrangements, histories of revenue raising, and political cultures of countries can be so different.

Many economists argue that a federation should minimize the extent to which constituent units use tax competition to influence companies and individuals to locate in a particular area. This suggests constituent units (and local governments) should have limited control over mobile taxpayers and tax bases (such as corporate and personal income tax and sales taxes). Instead, they should be given power over property taxes because property does not move. In practice, the mobility of taxpayers or taxable activity depends on cultural factors (are citizens very attached to living in their constituent unit?), on distance (is it easy to work or shop in another jurisdiction?), on geographic endowment (natural resources) and on technology (new technologies offer new locational choices).

At the same time, some economists favour fairly extensive tax competition (along with other kinds of competition in public policies) because they believe it can promote better policies: it is a potential advantage of federalism. Some economists argue that constituent units should have the right to vary the rates of personal and corporate taxes, but that it is economically efficient to have one (federally or jointly decided) definition of the tax base in these cases. There is no one answer about the best allocation of tax powers within federations. Too much competition between jurisdictions over taxes on mobile factors can lead to a downward spiral of tax rates, with a loss of revenues from some tax bases and a need to focus taxes more on other tax bases. But some competition can be positive.

There are other considerations about how best to assign tax and revenue powers:

- There are advantages to **making governments accountable** for the money they spend, and it is usually argued that they will be more accountable to their electors if they have to raise most of their revenues themselves.

- There are also **equity considerations** related to whether poorer constituent units should be expected to have a greater tax effort, lower services, or transfers to assist them.

- There can be **administrative advantages** to centralizing certain kinds of revenue collection, even if the revenue base belongs to constituent units.

Some federations are rich in natural resources, which can provide large revenues or rents, especially from oil, gas, diamonds, and some metals. Such resources are typically very unevenly distributed between constituent units, causing tension within the federation. In some cases, the central government owns these resources; in others, it is the constituent-unit governments (or, rarely, private landowners): in either case, there can be debates about who collects what revenues from natural resources, how resource revenues should be distributed, and how much the distribution of resource revenues should affect the distribution of other revenues.

Natural Resource Revenues in Some Federations

Natural-resource revenues come principally from royalties, licence fees, export taxes, and corporate taxes. They are by far the largest source of revenues in **Nigeria**, where the central government collects them, and then shares them with the states based on various principles, including equality of states, population, and derivation (more for the producing states). In

Russia, both royalties and export taxes are important, and the central government now dominates their collection with some small advantage for producing constituent units. **Argentina** transferred resources to the provinces and some small, resource-rich provinces now enjoy a substantial fiscal advantage. In **Canada**, Alberta (like other provinces) owns its resources and has almost twice the revenue-raising capacity of other provinces; the federal government has lost its power to apply export taxes to energy exports. In the **United States**, most resources are owned by the states or private individuals, but there are extensive federal lands in the Western states and Alaska. **Sudan** has a petroleum revenue-sharing arrangement that gives the larger share to South Sudan, which has a smaller population but is the main source of production. In most federations, the federal government owns and controls offshore resources and their revenues; in **Canada** the offshore provinces have been given the benefits of offshore revenues.

While various principles and considerations can help shape the revenue-raising system in a federation, the actual systems have been strongly influenced by several factors: the constitutional allocation of revenue powers, the history of which government has occupied which tax field, and the political culture of the country, which can favour competitiveness or conformity, as well as more, or less, centralization. The resulting revenue arrangements vary considerably across federations; in some, the central government dominates the levying and collection of revenues, while in others, the central, constituent-unit, and local governments all play a significant role.

Central-government revenues relative to total-government revenues across federations

In **Canada** and **Switzerland**, the central government collects around 45 per cent of total revenues, and in the **United States**, 54 per cent. There is a cluster of federations (**Austria, Australia, Belgium, Brazil, India, Germany**, and **Spain**) in which the central government collects between 60 to 75 per cent of total revenues. And there are some federations (**Argentina, Malaysia, Mexico, Nigeria, Russia, South Africa,** and **Venezuela**) where the federal government levies and collects over 80 per cent of revenues. **Nigeria** and **Venezuela** are the most extreme cases, with central revenues of 98 and 97 per cent respectively. The **European Union** is not a federation and its central revenues are around two per cent of total government revenues. Some non-federations are more decentralized in regards to raising revenue than are some highly centralized federations.

Spending shares between orders of government

Federations vary greatly in the extent of direct government spending done by the central, constituent-unit, and local governments respectively.

In some federations, the federal government dominates the delivery of programs, while, in others, constituent-unit and local-government expenditures are larger. These differences reflect constitutional arrangements, priorities in government spending (e.g., defence versus social programs), and political history and culture.

Central-Government Direct Spending Relative to Total Government Spending Across Federations

Switzerland, Canada, Belgium, and **Germany** are the federations where central government spending is smallest (30 to 40 per cent) as a share of total government spending. In the German case, this is because the Länder are responsible for delivering many federally legislated programs, while in the case of **Switzerland, Canada**, and **Belgium**, it reflects the importance of the responsibilities of the constituent units. Central direct spending in most federations (**Argentina, Australia, Austria, Brazil, India, Mexico, Nigeria, Russia, Spain, South Africa**, and the **United States**) falls between 45 to 60 per cent. At the extreme are **Malaysia** (84 per cent) and **Venezuela** (78 per cent). **Mexico, Nigeria,** and **Spain** were very centralized but have devolved spending significantly in recent years.

Central transfers to constituent units

In all federations, the central government raises more revenue than it spends for its own needs. This enables it to make fiscal transfers to the constituent-unit governments.

Federations vary in the degree to which revenue collection and program spending are centralized. But in all federations, the central government raises more revenues (including through borrowing) than it needs for its own direct spending, partly because of the advantages of significantly centralized revenue collection. Central governments make fiscal transfers to the constituent units—and sometimes directly to local governments—to enable them to better meet their responsibilities. The importance of these transfers varies: while in some federations constituent units depend overwhelmingly on transfers, in most federations, central transfers to the constituent units cover, on average, less than half of their spending. As a consequence, most federations have a fair measure of accountability by constituent governments to their populations for the revenues they raise relative to programs.

There can be heated debates in federations about whether the allocation of revenue raising, transfers, and responsibilities is fair. There is no simple technical solution to this because it depends in large measure on political judgments about priorities for public spending. The vertical fiscal gap is a term used for the difference between the spending of constituent units and their own source revenues.

Central Transfers Relative to Constituent-Unit Spending

The smallest central transfers relative to total constituent-unit spending are in **Canada, Switzerland,** and the **United States** (around 13 to 26 per cent); **Russia** and **Malaysia** have relatively low transfers (23 and 30 per cent respectively) in a context of highly centralized program spending, reflecting the weakness of their constituent units. **Germany** has significant revenue sharing, which brings total transfers there to 44 per cent. The **Australian** and **Indian** central governments are large funders of constituent units (46 per cent in both). **Spain** (73 per cent) and **Belgium** (68 per cent) provide large transfers since they are recent federations that have devolved program responsibilities far more than revenue powers. At the extreme are **South Africa**, **Nigeria**, and **Mexico**, where the constituent units are dependent on central transfers for more than 87 per cent of their revenues.

Fiscal inequality and redistribution

The wealth of constituent units within federations differs greatly, affecting their ability to raise own-source revenues. Most federations have provisions for dealing with these differences through greater transfers to poorer constituent units. There is great variation in the design and underlying principles for such transfer arrangements.

All countries have regional differences in wealth. Federations face a particular challenge in that the governments of the constituent units typically have the same or almost the same responsibilities, but they can have very different abilities to raise required revenues. Consequently, these governments would be able to provide programs of very unequal quality and scale if limited to their own revenues.

Federations deal with this problem in varied ways. Most federations (the US is a notable exception) use the principle of equalization, namely that there should be mechanisms to even up the revenues available to the different constituent-unit governments. Set against this, there is also a principle of derivation, namely that the jurisdiction that is the source of a particular revenue may have a special claim to all or part of that revenue: this principle is often invoked in relation to resource revenues (whatever the constitutional arrangements). Clearly there is a conflict between the equalization and derivation principles, and federations give quite different weight to each principle.

Most federations have some kind of **equalization** program or **revenue-sharing** arrangement that provides transfers from the central government to the constituent-unit governments (though in Germany and Switzerland it also includes transfers directly from the governments of richer constituent units to their poorer counterparts). These programs vary in their underlying approach.

- Some programs shrink gaps only in revenue capacity, which measures the ability to raise revenues, while others try to address revenue effort and revenue needs as well.

- Some rich federations bring all units to the same level (100 per cent equalization), while others bring them only within a broad range. (Germany did even more, with massive transfers—effectively superequalization—to permit the Eastern Länder to rebuild after reunification.)

- Some equalize only the poorer constituent units up to a standard, while others equalize all units, up and down, to a standard.

Equalization programs and revenue-sharing arrangements provide **unconditional** transfers, which the receiving governments can use for any purpose. In most federations, **conditional** transfers also play an important role; the central government attaches conditions to the purposes and manner in which these transfers are used. Conditional transfers are program specific so they may or may not contribute to equalizing the positions of constituent governments.

In many federations, there is debate over the size of unconditional versus conditional transfers: unconditional transfers tend to favour the independence of constituent-unit governments, while conditional transfers promote the achievement of national purposes and standards, e.g., healthcare. The United States is the great outlier in having no equalization program: all federal transfers are conditional; some have equalizing features, but the sum of federal transfers has no systematic equalizing impact.

Central governments also spend significant amounts on their own direct programs, so the regional location of central government spending can affect fiscal redistribution. No federation has explicit rules on this and it can be difficult to get good statistics on where exactly money is spent or who benefits from a particular expenditure (e.g., a military base in a constituent unit is protecting the whole country; a piece of machinery bought in one region for use in another benefits both). However, the regional impact of central government spending, especially large strategic investments, is frequently a political issue in federal systems. Social payments by central governments, such as on pensions and unemployment insurance, can have a large impact on net transfers between regions and levels of inequality.

Finally, views differ on the economic implications of equalization programs and revenue sharing:

- Advocates argue that they ensure comparable infrastructure and services throughout the federation, which is important for regional development as well as a high-quality workforce. They can also compensate for the lack of labour mobility caused by regional language differences.

- Critics argue that they drain money from the most competitive parts of a country and slow deeper structural adjustments, such as population movements from poorer regions.

Most federations seem sensitive to both arguments and fall somewhere between 'very ambitious' and 'no equalization'. Richer federations can usually afford a higher standard of equalization because the differences in wealth between their constituent units are much less than in transitional and developing-country federations. The design of equalization programs can affect the incentives for constituent governments to raise their own taxes and promote economic growth.

The spending power

Federations differ in the approach to spending by central governments in areas beyond their legislative jurisdiction. The spending power of a government can have important implications for the character of a federation.

All federations have a constitutional division of powers that constrains, at least to some extent, each order of government from making laws in areas of the others' jurisdiction. However, they often allow spending in the area of another government's exclusive legislative jurisdiction. Central governments frequently use this spending power to influence the programs and activities of constituent units, notably through conditional grants and shared-cost programs.

Legal Provisions around Spending Power in Some Federations

The constitutions of **Australia, India,** and **Malaysia** explicitly grant the central government the right to spend in areas beyond their jurisdiction (as does that of **Spain**, though subject to restrictive court interpretations). The **United States** Constitution gives the central government a power to levy taxes for general welfare, which has been interpreted broadly as no legal limit on federal spending. In **Canada**, court interpretation has given both orders of government unlimited spending powers, but there is a federal-provincial agreement that new federal-spending initiatives in areas of provincial competence would require majority support from the provinces and allow opting out by individual provinces, subject to certain conditions. The **Swiss** Constitution generally does not permit central spending in areas of exclusive cantonal jurisdiction, but, in practice, the only check on such spending would be through the use of referendums, not court rulings, and this has not happened. **Germany** is characterized by large areas of concurrent or joint jurisdiction, and many federal laws are administered by the Länder: all decisions on such spending require a majority of Länder in the upper chamber, where the votes of individual Länder are weighted. **Belgium** is rare in that its constitutional court has explicitly limited spending to areas of legislative competence.

While the use of the spending power for unconditional transfers is usually relatively uncontroversial, constituent units frequently object to its use for conditional transfers. There are several reasons:

- Central government conditions can effectively dictate the programs of constituent units in areas of their exclusive competency.

- Central government grants can distort constituent-unit priorities by requiring matching funds as a condition of receiving the grants.

- A central government can withdraw or reduce such transfers once a program is established by the constituent units, leaving them to deal with public expectations.
- Discretionary grants to constituent units can be used by the central government to favour its political friends and punish its adversaries, and even to distort electoral outcomes.

Against this, defenders of the spending power argue that it is different in kind from the legislative power. There is not the same need to establish paramountcy for spending because both orders of government can spend in the same area without creating a clear conflict or impasse. However, the main defence is that the spending power enables a federation to adapt and respond to changing circumstances and national needs.

Both sets of arguments have some validity, but, in practice, the spending power is a major feature of the operation of virtually all federations. So often the issue is over *how* it is used, not *whether*.

- There can be **formal** (Germany) or **informal** (Canada) rules requiring some level of constituent-unit consent. Canada has even experimented with opting-out arrangements for provinces that do not agree with an initiative; these provinces receive an equivalent amount to finance their own comparable program.

- There can be **varied degrees of conditionality** so as to give constituent units more flexibility to design programs that conform to a broad national standard or purpose. Once programs are established, this can even extend to converting conditional grants into unconditional transfers.

Conditionality and Spending Powers in Some Federations

In the **United States**, all transfers to states are conditional and they account for about 30 per cent of state-level revenues. In **Mexico**, 49 per cent of state revenues and, in **Spain**, 42 per cent of autonomous communities' revenues are conditional transfers. By contrast, **Canada, Belgium,** and **Russia** are at the other extreme with four or less per cent of their transfers being conditional (though, in Canada, many important social programs were originally started on a conditional basis and some current transfers are subject to very broad principles and reporting requirements). Conditional transfers are important in **Australia, India,** and **Switzerland**, where they account for 17 to 20 per cent of total revenues of constituent units. They are used as well to a lesser extent in **Germany** and **Malaysia**.